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SENSITIVE

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SUBJECT: ECONOMIC PARTNERSHIP COMMISSION SCENESETTER

SENSITIVE BUT UNCLASSIFIED

¶1. (SBU) We are delighted to welcome Assistant Secretary Sullivan and his delegation to Turkey for the third meeting of the Economic Partnership Commission (EPC). Resuming economic dialogue since the last meeting in Washington in December 2003 is an important part of the "Shared Vision and Structured Dialogue" agreed by Secretary Rice and Foreign Minister Gul last July. We want to use this EPC to launch a more serious and sustained bilateral dialogue on economic issues, trade, and investment. This will add balance to a bilateral relationship that has been heavily weighted to political and security cooperation, and it will help both sides cope with and move beyond turbulence in 2007 over Iraq-related issues and a likely Armenian genocide resolution in Congress.

#### Political and Economic Stability

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¶2. (SBU) After years of volatility, the relative political stability Turkey has enjoyed since the AK Party came to power in late 2002 has been an important part of Turkey's economic success. For the first time in decades, rampant inflation and government spending were brought under control and a single party enjoyed a parliamentary majority needed to pass essential reforms of the taxation, banking, and social security systems. Per capita GDP has doubled to \$5000 in four years. The resilience of Turkey's reforms was tested in May-June 2006, when approximately \$10 billion in foreign portfolio funds left the market as part of an emerging markets pullback and following the mishandling of a Central Bank leadership transition. What would have been a major crisis five years earlier did not materialize: the lira stabilized, foreign investors are returning in droves, and trade continues to boom.

#### Turbulent Year Ahead

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¶3. (SBU) We face a potentially turbulent year as Turkey enters an election period during which it will choose a new president in the spring and a new parliament closer to the end of the year. Emerging from these elections with a government and leadership with a strong mandate is essential if Turkey is to continue the reform process, particularly in addressing weaknesses in the judicial and educational systems. The OECD and World Bank identify these "second generation reforms" as essential for Turkey to sustain the high levels of growth it will need to make up for lost decades and catch-up with income levels in the EU. The ruling Justice and Development Party (AKP) will run on a good government platform, but there is a wide perception that the benefits of economic growth are not broadly shared and unemployment remains high.

14. (SBU) Passage by Congress of an "Armenian Genocide" resolution would deeply complicate our relationship and have a negative impact on the political climate here. When U/S Burns was here in mid-January, he stated clearly in his public and private meetings that the Administration would oppose such a resolution. You can carry the same message. To the extent that it is clear that the Administration strongly objected to a resolution, some of the bilateral damage can be offset. The murder of Turkish-Armenian journalist Hrant Dink may have created an opportunity for bilateral opening with Armenia, but the domestic politics are very difficult and this has yet to play out.

#### U.S. Companies Face Challenges

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15. (SBU) Your February 8-9 meetings with the private sector in Istanbul and with government officials in Ankara offer the opportunity to reinforce Turkey's commitment to economic openness and reform and to boost participation of U.S. companies in Turkey's economic success. Although U.S. trade with Turkey has grown in the past five years to today's annual level of about \$10 billion, the rate of growth has been far less than the overall growth in Turkey's total trade, so both countries have lost shares in each others' markets. Reform has also allowed Turkey to attract new direct investment inflows. A large portion of this has come from the United States, including \$4.7 billion in equity investment in the financial sector by Citigroup and GE Capital. However, the persistence of traditional ways of doing business, including corruption and perceptions of a biased judiciary, hold back greenfield investment. Some problems have been fixed, but Cargill's continuing difficulties and pharmaceutical companies' IPR issues show U.S. investors still don't always get a fair shake.

#### Reforms Create New Opportunities

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16. (SBU) Business and government leaders will appreciate hearing that reforms are paying off and need to continue. Indeed, you can say that private sector-led growth is creating new opportunities for interaction between our private sectors. The Citigroup and GE investments demonstrate this potential, but there are many new areas to explore in nearly all sectors. Business leaders are also looking for greater cooperation with U.S. companies in Turkey's neighborhood, where Turkey's economic dynamism has the potential to be an engine of growth and stability in the Middle East, Central Asia and the Caucasus, as well as in an emerging Black Sea region. The U.S. Chamber of Commerce's Eurasia Business Platform is one such regional vehicle. Turkey's national business federation, TOBB, has also been working to encourage Turkish investment in the Middle East, notably in Gaza's Erez Industrial Zone.

#### U.S. Support for EU Membership

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17. (SBU) Turkish leaders will also want to hear you reiterate U.S. support for Turkey's EU accession. In particular, it will be good for them to hear that the United States believes EU membership will make both Turkey and the EU stronger and be good for our relationships with both. Increased trade with the EU under its 1996 Customs Union has been an important part of Turkey's growth equation. However, full EU membership will require much more difficult economic adjustments, as it will require Turkey to dismantle much of its remaining protectionist infrastructure in agriculture and curb IPR abuse, as well as adopt expensive new standards in environmental protection. These transitions can, however, create opportunities for U.S. companies and for bilateral cooperation. Improving agricultural productivity through adoption of U.S. technology and greater use of cost-saving U.S. environmental technologies are two such openings.

#### Energy: Domestic as Well as Regional

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18. (SBU) While an important part of your focus is on regional energy, Turkey's domestic energy sector is an example of how economic reform is opening new opportunities for U.S. companies. For example, most projections are that Turkish electricity demand will outstrip supply in the next two to three years. Turkish officials realize that they need new capacity, but are having difficulty creating a regulatory environment conducive to the long-term investments required, including in civilian nuclear power generation. In addition, Turkey will struggle to meet EU environmental standards and improve energy efficiency. Getting input from potential foreign investors on the regulatory climate and enhanced commercial cooperation can help meet both these objectives, as could DOE-proposed workshops on energy efficiency and clean coal technology.

#### Innovation

19. (SBU) Private sector-led economic growth is opening new opportunities to increase bilateral science and technology cooperation. Turkey's traditional "top-down" approach to innovation has not been conducive to the development and use of new technologies that create value and meet the needs of individuals. Turkey ranked among the lowest countries on most indicators of innovation according to a 2004 European Commission "Innovation Scorecard." But along with new sources of government funding, new private universities and innovative companies are emerging. We plan to take advantage of this by hosting a conference later this year with the American Business Forum in Turkey (ABFT) that will highlight the elements of success as an "innovative economy," including world-class intellectual property protection. Your announcing plans to sign a new bilateral S&T agreement would also be a positive signal.

#### Building on Hopes

10. (SBU) A metaphor used by the World Bank is that of Turkey as a patient who has left the emergency room and moved to intensive care, but has a long time to go before leaving the hospital. There is a real risk of a loss of reform momentum and relapse into the political and economic instability and stagnation that have been more the norm than the exception. Vulnerabilities include the large dependence on foreign financing of imports reflected in the 8.5% of GDP current account deficit, still widespread poverty and unemployment, a backwards rural sector and broken agriculture

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policy, and more fundamentally, unsettled issues of Turkish identity, including religious identity, and the relationship between individuals and government. For the first time in years, however, there is hope for the future. We especially see this when we travel to some of the regional centers outside Ankara and Istanbul that are beginning to prosper after years of neglect.

11. (SBU) A better relationship with the United States is part of this hope, and much of that will come with greater commercial interaction. The cooperation between the U.S. Chamber of Commerce and its Turkish counterpart, TOBB, that resulted from earlier EPC meetings was very successful this past summer, holding seminars on doing business with the U.S. in five Turkish cities. The "Business Forum" you will lead in Istanbul is an excellent opportunity for business and government leaders to work together to devise plans to realize these hopes. We hope this Forum will become a regular part of the EPC process. Finding other structured ways to build on these hopes and improve awareness in the United States and in Turkey of mutual opportunities, including follow-on programs between the Chamber and TOBB, would be important outcomes from this meeting that would help lay the groundwork for the next meeting and for a deeper, self-sustaining economic dialogue.

WILSON